# *Consolidated Financial Statements*

## *as of December 31, 2003*

**(In U.S. dollars)**

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# REPORT OF INDEPENDENT AUDITORS

To the Shareholders of Elbit Systems Ltd.

We have audited the accompanying consolidated balance sheet of Elbit Systems Ltd. (the "Company") and its subsidiaries as of December 31, 2003, and the related consolidated statements of income, changes in shareholders' equity and cash flows for the year ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2003, and the consolidated results of their operations and cash flows for the year ended December 31, 2003, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 2 to the consolidated financial statements, effective January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible assets".

**Kost Forer Gabbay & Kasierer**
A member of Ernst & Young Global

Haifa, Israel,
March 9, 2004

# REPORT OF INDEPENDENT AUDITORS

To the Shareholders of Elbit Systems Ltd.

We have audited the accompanying consolidated balance sheet of Elbit Systems Ltd. (the "Company") and its subsidiaries as of December 31, 2002, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. The financial statements of Elbit Systems Ltd. As of December 31, 2001 and for the year then ended were audited by other auditors who have ceased operations as a foreign associated firm of the Securities and Exchange Commission Practice Section of the American Institute of Certified Public Accountants and whose report dated March 24, 2002, expressed an unqualified opinion on those statements.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2002 and the consolidated results of their operations and cash flows fro the year then ended in conformity with accounting principles generally accepted in the United States.

As discussed in Note 2 to the consolidated financial statements, the Company adopted the provisions of Statement of Financial Accounting Standards No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets, effective January 1, 2002.

**Luboshitz Kasierer**
An affiliate member of Ernst & Young International

Haifa, Israel,
March 10, 2003

# REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

This is a copy of the previously issued Independent Public Account's report of Arthur Andersen. The report has not been reissued by Arthur Andersen.

To the Shareholders of Elbit Systems Ltd.

We have audited the accompanying consolidated balance sheets of Elbit Systems Ltd. and its subsidiaries as of December 31, 2001 and 2000 and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Elbit Systems Ltd. and its subsidiaries as of December 31, 2001 and 2000, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

**Luboshitz Kasierer**
Arthor Andersen

Haifa, Israel,
March 24, 2002

# ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES – CONSOLIDATED BALANCE SHEETS

U.S. dollars (In thousands)

| | Note | December 31 2003 | 2002 |
|---|---|---|---|
| ***CURRENT ASSETS*** | | | |
| Cash and cash equivalents | | $76,156 | $76,280 |
| Short-term bank deposits | | 690 | 1,650 |
| Trade receivables, net | (3) | 203,281 | 225,773 |
| Other receivables and prepaid expenses | (4) | 48,363 | 42,698 |
| Inventories, net of advances | (5) | 249,225 | 220,399 |
| ***Total current assets*** | | **577,715** | **566,800** |
| ***INVESTMENTS AND LONG-TERM RECEIVABLES*** | | | |
| Investments in affiliated companies and partnership | (6A) | 26,478 | 21,947 |
| Investments in other companies | (6B) | 11,745 | 11,104 |
| Long-term trade receivables | | 393 | 20,859 |
| Long-term bank deposits and loan | (7) | 1,954 | 3,686 |
| Severance pay fund | (2N) | 76,218 | 67,024 |
| | | **116,788** | **124,620** |
| ***PROPERTY, PLANT AND EQUIPMENT, NET*** | (8) | **229,221** | **202,961** |
| ***OTHER ASSETS, NET*** | (9) | | |
| Goodwill | | 32,576 | 32,162 |
| Know-how and other intangible assets, net | | 67,436 | 73,607 |
| | | **100,012** | **105,769** |
| | | **$ 1,023,736** | **$ 1,000,150** |

*The accompanying notes are an integral part of the consolidated financial statements*

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES – CONSOLIDATED BALANCE SHEETS (cont.)

U.S. dollars (In thousands, except per share data)

| | Note | December 31 2003 | 2002 |
|---|---|---|---|
| ***CURRENT LIABILITIES*** | | | |
| Short-term bank credit and loans | (10) | $8,509 | $24,302 |
| Current maturities of long-term loans | (13) | 6,818 | 6,613 |
| Trade payables | | 107,545 | 82,094 |
| Other payables and accrued expenses | (11) | 156,527 | 141,304 |
| Customers advances and amounts in excess of costs incurred on contracts in progress | (12) | 99,618 | 106,467 |
| ***Total current liabilities*** | | **379,017** | **360,780** |
| ***LONG-TERM LIABILITIES*** | | | |
| Long-term loans | (13) | 62,038 | 73,173 |
| Advances from customers | (12) | 7,592 | 40,411 |
| Deferred income taxes | (15E) | 24,916 | 24,735 |
| Accrued severance pay | (14,2N) | 93,979 | 84,973 |
| | | **188,525** | **223,292** |
| ***COMMITMENTS AND CONTINGENT LIABILITIES*** | (16) | | |
| ***MINORITY INTERESTS*** | | ***4,115*** | ***4,717*** |
| ***SHAREHOLDERS' EQUITY*** | (17) | | |
| Share capital | | | |
| Ordinary shares of New Israeli Shekels (NIS) 1 par value; Authorized - 80,000,000 shares as of December 31, 2003 and 2002; Issued - 39,746,125 and 39,212,328 shares as of December 31, 2003 and 2002, respectively; Outstanding - 39,337,304 and 38,803,507 shares as of December 31, 2003 and 2002, respectively | | 11,273 | 11,154 |
| Additional paid-in capital | | 259,033 | 248,387 |
| Accumulated other comprehensive loss | | (3,992) | (2,882) |
| Retained earnings | | 190,086 | 159,023 |
| Treasury shares - 408,821 shares as of December 31, 2003 and 2002 | | (4,321) | (4,321) |
| | | **452,079** | **411,361** |
| | | **$1,023,736** | **$1,000,150** |

*The accompanying notes are an integral part of the consolidated financial statements*

# CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. dollars (In thousands, except per share data)

| | Note | Year ended December 31 2003 | 2002 | 2001 |
|---|---|---|---|---|
| Revenues | (18) | $897,980 | $827,456 | $764,501 |
| Cost of revenues | | 673,561 | 605,313 | 553,957 |
| ***Gross profit*** | | **224,419** | **222,143** | **210,544** |
| Research and development costs, net | (19) | 54,919 | 57,010 | 58,759 |
| Marketing and selling expenses | | 69,943 | 65,691 | 54,876 |
| General and administrative expenses | | 46,077 | 41,651 | 43,216 |
| | | **170,939** | **164,352** | **156,851** |
| ***Operating income*** | | **53,480** | **57,791** | **53,693** |
| Financial expenses, net | (20) | (4,870) | (3,035) | (2,617) |
| Other income (expenses), net | (21) | 903 | (462) | 774 |
| ***Income before taxes on income*** | | **49,513** | **54,294** | **51,850** |
| Taxes on income | (15) | 11,334 | 9,348 | 11,003 |
| | | **38,179** | **44,946** | **40,847** |
| Equity in net earnings (losses) of affiliated companies and partnerships | | 7,209 | 675 | (598) |
| Minority interests in losses (earnings) of subsidiaries | | 557 | (508) | 547 |
| ***Net income*** | | **$45,945** | **$45,113** | **$40,796** |
| **Earnings per share** | (17G) | | | |
| ***Basic net earnings per share*** | | **$1.18** | **$1.17** | **$ 1.07** |
| ***Diluted net earnings per share*** | | **$1.14** | **$1.13** | **$ 1.04** |

*The accompanying notes are an integral part of the consolidated financial statements*

# STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S.dollars (In thousands, except per share data)

| | Number of outstanding shares | Share capital | Additional paid-in capital | Accumulated other comprehensive loss | Retained earnings | Treasury shares | Total Share-holders' equity | Total comprehensive income |
|---|---|---|---|---|---|---|---|---|
| ***Balance as of January 1, 2001*** | **37,811,398** | **$10,916** | **$ 235,462** | **$ -** | **$ 97,963** | **$ (3,613)** | **$ 340,728** | |
| Exercise of options | 585,860 | 138 | 3,162 | - | - | - | 3,300 | |
| Tax benefit in respect of options exercised | - | - | 1,363 | - | - | - | 1,363 | |
| Adjustment to capital reserve | - | - | (3,874) | - | - | - | (3,874) | |
| Amortization of stock based compensation | - | - | 8,512 | - | - | - | 8,512 | |
| Purchase of treasury shares | (66,986) | - | - | - | - | (708) | (708) | |
| Dividend Paid | - | - | - | - | (12,132) | - | (12,132) | |
| Net income | - | - | - | - | 40,796 | - | 40,796 | $40,796 |
| Total comprehensive income | - | - | - | - | - | - | - | **$40,796** |
| **Balance as of *December 31, 2001*** | **38,330,272** | **11,054** | **244,625** | **-** | **126,627** | **(4,321)** | **377,985** | |
| Exercise of options | 473,235 | 100 | 4,040 | - | - | - | 4,140 | |
| Tax benefit in respect of options exercised | - | - | 648 | - | - | - | 648 | |
| Amortization of stock based compensation | - | - | (926) | - | - | - | (926) | |
| Dividend Paid | - | - | - | - | (12,717) | - | (12,717) | |
| Comprehensive income (loss): Minimum pension liability | - | - | - | (2,882) | - | - | (2,882) | $(2,882) |
| Net income | - | - | - | - | 45,113 | - | 45,113 | 45,113 |
| Total comprehensive income | - | - | - | - | - | - | - | **$42,231** |
| **Balance as of *December 31, 2002*** | **38,803,507** | **$11,154** | **$248,387** | **$(2,882)** | **$159,023** | **$(4,321)** | **$411,361** | |
| Exercise of options | 533,797 | 119 | 5,147 | - | - | - | 5,266 | |
| Tax benefit in respect of options exercised | - | - | 758 | - | - | - | 758 | |
| Amortization of stock based compensation | - | - | 4,741 | - | - | - | 4,741 | |
| Dividend Paid | - | - | - | - | (14,882) | - | (14,882) | |
| Comprehensive income (loss): Unrealized gains on derivative instruments | - | - | - | (578) | - | - | (578) | $(578) |
| Foreign currency translation differences | - | - | - | 340 | - | - | 340 | 340 |
| Minimum pension liability | - | - | - | (872) | - | - | (872) | (872) |
| Net income | - | - | - | - | 45,945 | - | 45,945 | 45,945 |
| Total comprehensive income | | | | | | | | **$44,835** |
| **Balance as of *December 31, 2003*** | **39,337,304** | **$11,273** | **$259,033** | **$(3,992)** | **$190,086** | **$(4,321)** | **$452,079** | |

| **Accumulated other comprehensive loss** | |
|---|---|
| Accumulated gains on derivative instruments | $ (578) |
| Accumulated foreign currency translation differences | 340 |
| Accumulated minimum pension liability | (3,754) |
| Accumulated other comprehensive loss December 31, 2003 | $(3,992) |

*The accompanying notes are an integral part of the consolidated financial statements*

# CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars (In thousands)

| | Year ended December 31 | | |
|---|---|---|---|
| | 2003 | 2002 | 2001 |
| ***CASH FLOWS FROM OPERATING ACTIVITIES*** | | | |
| ***Net income*** | **$45,945** | **$45,113** | **$40,796** |
| Adjustments required to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 37,890 | 32,937 | 32,865 |
| Amortization of deferred stock based compensation | 4,741 | (926) | 8,512 |
| Deferred income taxes, net | 35 | (5,620) | (2,694) |
| Accrued severance pay, net | (1,240) | 6,260 | (633) |
| Gain (loss) on sale of property, plant and equipment | (915) | 743 | (327) |
| Tax benefit in respect of options exercised | 758 | 648 | 1,363 |
| Minority interests in earnings (losses) of subsidiaries | (557) | 508 | (547) |
| Equity in net losses (earnings) of affiliated companies and partnership, dividend received (*) | (4,995) | (675) | 598 |
| Changes in operating assets and liabilities: | | | |
| Decrease (increase) in short and long-term receivables and prepaid expenses | 45,297 | 58,554 | (9,963) |
| Increase in inventories | (38,651) | (55,106) | (72,165) |
| Increase (decrease) in trade payable, other payables and accrued expenses | 32,147 | (19,321) | 37,004 |
| Increase (decrease) in advances received from customers | (27,855) | 42,999 | 6,489 |
| Settlement of royalties with the Office of the Chief Scientist | (1,581) | 9,197 | - |
| Other adjustments | 337 | 683 | (117) |
| ***Net cash provided by operating activities*** | **91,356** | **115,994** | **41,181** |
| ***CASH FLOWS FROM INVESTING ACTIVITIES*** | | | |
| Purchase of property, plant and equipment | (61,287) | (46,003) | (45,244) |
| Investment grants received for property, plant and equipment | - | 119 | 1,334 |
| Acquisition of subsidiaries and businesses (Schedule A) | (2,458) | (5,280) | (3,344) |
| Investments in affiliated companies and subsidiaries | (1,049) | (1,681) | (801) |
| Proceeds from sale of property, plant and equipment | 5,815 | 956 | 3,010 |
| Grant of long-term loan | - | (714) | - |
| Repayment of long-term loan | 2,400 | - | - |
| Repayment of short-term loan | - | 1,371 | - |
| Investment in long-term bank deposits | (1,750) | (1,228) | (1,872) |
| Proceeds from sale of long-term bank deposits | 3,568 | 1,689 | 2,322 |
| Short-term bank deposits, net | 960 | (204) | (57) |
| ***Net cash used in investing activities*** | **(53,801)** | **(50,975)** | **(44,652)** |

*The accompanying notes are an integral part of the consolidated financial statements*

## CONSOLIDATED STATEMENTS OF CASH FLOWS (cont.)

U.S. dollars (In thousands)

| | Year ended December 31 | | |
|---|---|---|---|
| | **2003** | **2002** | **2001** |
| ***CASH FLOWS FROM FINANCING ACTIVITIES*** | | | |
| Proceeds from exercise of options | 5,266 | 4,140 | 3,300 |
| Repayment of long-term credit for purchase of a building | - | - | (3,000) |
| Purchase of treasury shares | - | - | (708) |
| Repayment of long-term bank loans | (27,066) | (3,249) | (13,049) |
| Proceeds from long-term bank loans | 10,000 | 2,233 | 25,444 |
| Dividends paid | (14,882) | (12,717) | (12,132) |
| Change in short-term bank credit and loans, net | (10,997) | (19,729) | (6,517) |
| ***Net cash used in financing activities*** | **(37,679)** | **(29,322)** | **(6,662)** |
| ***NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS*** | **(124)** | **35,697** | **(10,133)** |
| ***CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR*** | **76,280** | **40,583** | **50,716** |
| ***CASH AND CASH EQUIVALENTS AT END OF YEAR*** | **$76,156** | **$76,280** | **$40,583** |
| (*) Dividend received | **$ 2,214** | **$ -** | **$ -** |
| ***SUPPLEMENTARY CASH FLOWS ACTIVITIES:*** | | | |
| Cash paid during the year for: | | | |
| ***Income taxes*** | **$14,666** | **$ 21,730** | **$ 9,469** |
| ***Interest*** | **$ 4,034** | **$ 2,947** | **$ 6,649** |
| ***SCHEDULE A:*** | | | |
| ***Subsidiaries and activities acquired (*)*** | | | |
| Estimated net fair value of assets acquired and liabilities assumed at the date of acquisition was as follows: | | | |
| Working capital deficiency (excluding cash and cash equivalents) | $ 657 | $ - | $ 888 |
| Property, plant and equipment | (249) | (275) | (1,886) |
| Goodwill, know-how and other intangible assets | (1,334) | (5,078) | (3,800) |
| Deferred income taxes | (1,765) | - | - |
| Long-term liabilities | 198 | - | 1,454 |
| Minority interest | 35 | - | - |
| | **(2,458)** | **(5,353)** | **(3,344)** |
| Less short-term debt incurred on acquisition | - | 73 | - |
| | **$ (2,458)** | **$ (5,280)** | **$ (3,344)** |

* AEL in 2001 (see Note 1C). Defense systems division of Elron Telesoft in 2002 (see Note 1D). In 2003 a Belgian subsidiary (see Note 1E) and AD&D (see Note 1F).

*The accompanying notes are an integral part of the consolidated financial statements*

## *Note 1 – GENERAL*

**A.** Elbit Systems Ltd. (the "Company") is an Israeli corporation, 30% owned by the Federmann Group and 20% owned by Elron Electronic Industries Ltd. ("Elron"). The Company's shares are traded on the Tel Aviv Stock Exchange and on the Nasdaq National Market in the United States. The Company and its subsidiaries (the "Group") are engaged mainly in the field of defense electronics. The Company's principal wholly owned subsidiaries are EFW Inc. ("EFW") and Elop Electro-Optics Industries Ltd. ("El-Op").

**B.** A majority of the Group's revenues were derived in recent years from direct or indirect sales to governments or to government agencies. As a result, a substantial portion of the Group's sales is subject to the special risks associated with sales to governments or to government agencies. These risks include, among others, the dependency on the resources allocated by governments to defense programs, changes in governmental priorities and changes in governmental approvals regarding export licenses required for the Group products and for its suppliers. As for a major customer refer to Note 18C.

**C.** In 2001, the Company acquired a 62.5% interest in Aeroeletronica - Industria de Componentes Avionicos S.A. ("AEL"), a Brazilian company located in Porto Alegre, for approximately $3,450 in cash. In July 2002, the Company acquired the remaining 37.5% interest for an additional $900 in cash. The consideration paid included approximately $1,200 held in escrow, pending final resolution of certain liabilities and contingencies of AEL to be resolved over a period of five years following the acquisition. The excess of cost over the fair value of net liabilities acquired of approximately $6,700 was allocated to land ($1,200) and identifiable intangible assets ($5,500), to be amortized over a period of 8 years.

AEL serves as a center for the production and logistics support of defense electronics for programs in Brazil.

The results of AEL's operations have been included in the consolidated financial statements from the date of acquisition.

Pro forma information in accordance with Statement of Financial Accounting Standards No. 141 "Business Combinations" ("SFAS No. 141") has not been provided, since the revenues and net income of AEL were not material in relation to total consolidated revenues and net income for the year 2001.

## *Note 1 – GENERAL (Cont.)*

**D.** In January 2002, the Company acquired from Elron Telesoft Inc. and its subsidiaries ("Elron Telesoft") the assets and the business of the Defense Systems Division of Elron Telesoft ("the Government Division") in consideration for $5,700 in cash. The excess of the purchase price over the fair value of net tangible assets acquired in the amount of approximately $5,100 was allocated to technology and other intangible assets to be amortized over a weighted average period of 3 years.

The Government Division is engaged mainly in the development of communication systems, information technology and image intelligence processing for defense and military applications.

The results of the Government Division have been included in the consolidated financial statements from the first quarter of 2002.

Pro forma information in accordance with SFAS No. 141 has not been provided, since the revenues and net income of the Government Division were not material in relation to total consolidated revenues and net income for the years 2001 and 2002.

**E.** In June 2003, the Company (through El-Op) acquired all of the outstanding Ordinary shares of a Belgian subsidiary, in consideration for $1,846 in cash. The acquisition was accounted for by the purchase method of accounting.

This subsidiary develops, manufactures and supports electro-optical products, mainly for the defense and space markets.

The following table summarizes the fair values of the assets acquired and liabilities assumed at the date of acquisition as estimated by the Company:

| | |
|---|---|
| Current assets | $6,896 |
| Property and equipment | 168 |
| Deferred tax assets | 1,700 |
| **Total assets acquired** | **8,764** |
| Current liabilities | (6,918) |
| **Net assets acquired** | **$1,846** |

The results of the Belgian subsidiary's operations have been included in the consolidated financial statements from the date of acquisition.

Pro forma information in accordance with SFAS No. 141 has not been provided, since the revenues and net income of the subsidiary were not material in relation to total consolidated revenues and net income for the years 2001, 2002 and 2003.

## *Note 1 – GENERAL (Cont.)*

**F.** In July 2003, the Company acquired approximately 54% of the outstanding shares of Aero Design Development Ltd. ("AD&D") an Israeli company in consideration for $1,406 in cash. The acquisition was accounted for by the purchase method of accounting.

AD&D develops, manufactures and builds airborne models and other engineered products.

The purchase price over the fair value of net tangible assets acquired in the amount of approximately $1,334 was allocated to know-how ($1,000) to be amortized by the straight-line method over a period of 10 years and to goodwill ($334).

The following table summarizes the fair values of the assets acquired and liabilities assumed at the date of acquisition as estimated by the Company:

| | |
|---|---|
| Current assets | $604 |
| Property and equipment | 81 |
| Know-how and goodwill | 1,334 |
| Deferred tax assets | 65 |
| **Total assets acquired** | **2,084** |
| Current liabilities | (445) |
| Long-term liabilities | (198) |
| Minority interest | (35) |
| **Net assets acquired** | **$1,406** |

The results of AD&D's operations have been included in the consolidated financial statements from the date of acquisition.

Pro forma information in accordance with SFAS No. 141 has not been provided, since the revenues and net income of AD&D were not material in relation to total consolidated revenues and net income for the years 2001, 2002 and 2003 .

## *Note 2 – SIGNIFICANT ACCOUNTING POLICIES*

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States ("U.S. GAAP"). As applicable to the consolidated financial statements of the Group, such principles are substantially identical to accounting principles generally accepted in Israel, except as described in Note 23.

**A. USE OF ESTIMATES**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported and disclosure of contingent assets and liabilities in the financial statements and accompanying notes. Actual results could differ from those estimates.

## *Note 2 – SIGNIFICANT ACCOUNTING POLICIES (Cont.)*

### B. FINANCIAL STATEMENTS IN U.S. DOLLARS

The Company's revenues are generated mainly in U.S. dollars. In addition, most of the Company's costs are incurred in U.S. dollars. The Company's management believes that the U.S. dollar is the primary currency of the economic environment in which the Company operates. Thus, the functional and reporting currency of the Company is the U.S. dollar.

Transactions and balances originally denominated in U.S. dollars are presented at their original amounts. Transaction and balances in other currencies have been remeasured into U.S. dollars in accordance with principles set forth in SFAS No. 52 "Foreign Currency Translation". All exchange gain and losses from the remeasurement mentioned above are reflected in the statement of income in financial income or expenses.

For those foreign subsidiaries whose functional currency has been determined to be other than the U.S. dollar, assets and liabilities are translated at year-end exchange rates and statement of income items are translated at average exchange rates prevailing during the year. Such translation adjustments are recorded as a separate component of accumulated other comprehensive income in shareholders' equity.

### C. PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly and majority-owned subsidiaries.

The consolidated subsidiaries include El-Op, EFW and other Israeli and non-Israeli subsidiaries.

Intercompany transactions and balances including profit from intercompany sales not yet realized outside the Group have been eliminated upon consolidation.

### D. CASH EQUIVALENTS

Cash equivalents, are short-term highly liquid investments that are readily convertible to cash with maturities of three months or less at the date of acquisition.

### E. SHORT-TERM BANK DEPOSITS

Short-term bank deposits are deposits with maturities of more than three months but less than one year. The short-term bank deposits are presented at their cost.

## *Note 2 – SIGNIFICANT ACCOUNTING POLICIES (Cont.)*

**F. INVENTORIES**

Inventories are stated at the lower of cost or net realizable value. Inventory write-offs are provided for slow-moving items or technological obsolescence for which recoverability is not probable.

Cost is determined as follows:

- Raw materials using the average cost method.
- Costs incurred on long-term contracts in progress represent recoverable costs incurred for production, allocable operating overhead and, where appropriate, research and development costs (refer to Note 2Q).

Advances from customers are allocated to the applicable contract inventories and are reflected as an offset against the related inventory balances.

**G. INVESTMENT IN AFFILIATED COMPANIES, PARTNERSHIP AND OTHER COMPANIES**

Investments in non-marketable shares of companies in which the Group holds less than 20% and the Group does not have the ability to exercise significant influence over operating and financial policies of the companies are recorded at the lower of cost or estimated fair value.

Investments in companies and partnership over which the Group can exercise significant influence (generally, entities in which the Group holds between 20% and 50% of voting rights) are presented using the equity method of accounting. Profits on intercompany sales, not realized outside the Group, were eliminated. The Group discontinues applying the equity method when its investment (including advances and loans) is reduced to zero and it has not guaranteed obligations of the affiliate or otherwise committed to provide further financial support to the affiliate.

Certain investments are accounted for under the hypothetical liquidation method. For these investments, the Group applies Emerging Issues Task Force ("EITF 99-10"), "Percentage Used to Determine the Amount of Equity Method Losses", according to which the Group recognizes equity method losses based on the ownership level of the particular investee security or loan held by the Group to which the equity method losses are being applied.

The Group's investments in affiliates are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an investment may not be recoverable. As of December 31, 2003, based on management's most recent analyses, no impairment losses have been identified.

**H. LONG-TERM TRADE RECEIVABLES**

Long-term trade receivables from extended payment agreements are recorded at their estimated present values (determined based on the original rates of interest).

**I. LONG-TERM BANK DEPOSITS**

Bank deposits with maturities of more than one year are presented at cost including accumulated interest.

## *Note 2 – SIGNIFICANT ACCOUNTING POLICIES (Cont.)*

### J. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment are stated at cost, net of accumulated depreciation and investment grants. For equipment produced for the Group's own use, cost includes materials, labor and overhead, but not in excess of the fair value of the equipment. Depreciation is calculated by the straight-line method over the estimated useful life of the assets at the following annual rates:

| | % | |
|---|---|---|
| Buildings | 2 - 4 | (mainly 4%) |
| Instruments, machinery and equipment | 10 - 33 | |
| Office furniture and other | 6 - 33 | |
| Motor vehicles | 15 - 33 | (mainly 15%) |

Land rights and leasehold improvements - over the term of the lease.

### K. IMPAIRMENT OF LONG-LIVED ASSETS

The Group's long-lived assets and certain identifiable intangible assets are reviewed for impairment in accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the asset. If an asset is determined to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value. As of December 31, 2003, no impairment losses have been identified.

### L. OTHER ASSETS

Intangible assets subject to amortization arose from acquisitions prior to July 1, 2001, are being amortized on a straight-line basis over their useful life in accordance with APB Opinion No. 17, "Intangible Assets" ("APB No. 17").

Intangible assets acquired in a business combination for which date is on or after July 1, 2001, are being amortized over their useful life using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with Statements of Financial Accounting Standards No. 142 "Goodwill and Other Intangible Assets", ("SFAS No. 142").

### M. GOODWILL

Goodwill represents excess of the cost of acquired entities over the net fair values of the assets acquired and liabilities assumed. Goodwill that arose from acquisitions prior to July 1, 2001, was amortized until December 31, 2001, on a straight-line basis over 10 - 20 years. Under SFAS No. 142, such goodwill shall no longer be amortized effective as of January 1, 2002. Goodwill acquired in a business combination on or after July 1, 2001 is not amortized.

## *Note 2 – SIGNIFICANT ACCOUNTING POLICIES (Cont.)*

**M. GOODWILL (Cont.)**

SFAS No. 142 requires goodwill to be tested for impairment on adoption and at least annually thereafter or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill attributable to each of the reporting units is tested for impairment by comparing the fair value of each reporting unit with its carrying value. If the carrying value exceeds the fair value, impairment is measured by comparing the implied fair value of goodwill to its carrying value. Fair value of a reporting unit is determined using discounted cash flows. Significant estimates used in the methodology include estimates of future cash flows, future short-term and long-term growth rates and weighted average cost of capital for each of the reporting units. As of December 31, 2003, no impairment losses have been identified.

The adoption of SFAS 142 did not affect the financial position and results of operations of the Group as of January 1, 2002.

**N. SEVERANCE PAY**

Under Israeli law and employment agreements, the Group's companies in Israel are required to make severance payments and, in certain situations, pay pensions to terminated employees. The calculation is based on the employee's latest salary and the period of his employment. The companies' obligation for severance pay and pension is provided by monthly deposits with insurance companies, pension funds and by an accrual.

The value of severance pay funds is presented in the balance sheet and includes profits accumulated to balance sheet date. The amounts deposited may be withdrawn only after fulfillment of the obligations pursuant to Israeli severance pay law or labor agreements. The value of the deposited funds are based on the cash surrendered value of these funds and include immaterial profits.

Severance pay expenses for the years ended December 31, 2003, 2002 and 2001, amounted to approximately $11,491, $10,138 and $8,097, respectively.

**O. REVENUE RECOGNITION**

The Group generates revenues from long-term contracts involving the design, development, manufacture and integration of defense systems and products and providing support and services for such systems and products. Revenues from long-term contracts are recognized based on Statement of Position 81-1 "Accounting for Performance of Construction-Type and Certain Production - Type Contracts" ("SOP 81-1") on the percentage of completion method.

Sales and anticipated profit under long-term fixed-price production type contracts are recorded on a percentage of completion basis, generally using units of delivery as the measurement basis for effort accomplished. Estimated contract profit is included in earnings in proportion to recorded sales.

Sales under certain long-term fixed-price contracts which, among other things require a significant amount of development effort in relation to total contract value, are recorded using the cost-to-cost method of accounting where sales and profit are recorded based on the ratio of costs incurred to estimated total costs at completion but not before the Group achieves certain milestones. As for research and development costs accounted for as contract costs refer to Note 2Q.

## *Note 2 – SIGNIFICANT ACCOUNTING POLICIES (Cont.)*

**O. REVENUE RECOGNITION (Cont.)**

Sales under long-term fixed-price development and production type contracts are recorded on a percentage of completion basis using cost-to-cost method and units of delivery method, as applicable.

Estimated gross profit or loss from long-term contracts may change due to changes in estimates resulting from differences between actual performance and original forecasts. Such changes in estimated gross profit are recorded in results of operations when they are reasonably determinable by management, on a cumulative catch-up basis.

Amounts representing contract change orders, claims or other items are included in sales only when they can be reliably estimated and realization is probable. Penalties and awards applicable to performance on contracts are considered in estimating sales and profit rates, and are recorded when there is sufficient information to assess anticipated contract performance.

The Group believes that the use of the percentage of completion method is appropriate as the Group has the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights regarding services to be provided and received by the parties to the contracts, the consideration to be exchanged and the manner and terms of settlement. In all cases the Group expects to perform its contractual obligations and its customers are expected to satisfy their obligations under the contract. Anticipated losses on contracts are charged to earnings when identified.

Sales under cost-reimbursement-type contracts are recorded as costs are incurred. Applicable estimated profits are included in earnings in the proportion that incurred costs bear to total estimated costs.

**P. WARRANTY**

The Group estimates the costs that may be incurred under its basic warranty and records a liability in the amount of such costs at the time revenue is recognized. The specific terms and conditions of those warranties vary depending upon the product sold and the country in which the Group does business. Factors that affect the Group's warranty liability include the number of delivered units, engineering estimates and anticipated rates of warranty claims. The Group periodically assesses the adequacy of its recorded warranty liability and adjusts the amount as necessary.

Changes in the Group's provision for warranty during the year are as follows:

| | |
|---|---|
| Balance, at January 1, 2003 | $ 8,541 |
| Warranties issued during the year | 4,491 |
| Warranties forfeited or exercised during the year | (3,340) |
| **Balance, at December 31, 2003** | **$ 9,692** |

## *Note 2 – SIGNIFICANT ACCOUNTING POLICIES (Cont.)*

**Q. RESEARCH AND DEVELOPMENT COSTS**

Research and development costs, net of participations, are charged to operations as incurred.

Group sponsored research and development costs primarily include independent research and development and bid and proposal efforts.

Under certain arrangements in which a customer shares in product development costs, the Group's portion of such unreimbursed costs is expensed as incurred. Customer-sponsored research and development costs incurred pursuant to contracts are accounted for as contract costs.

Certain Group companies in Israel receive grants (mainly royalty-bearing) from the Government of Israel and from other sources for the purpose of funding approved research and development projects. These grants are recognized at the time the applicable company is entitled to such grants on the basis of the costs incurred and are presented as a deduction from research and development costs.

**R. INCOME TAXES**

The Group accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes". This Statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Group provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

**S. CONCENTRATION OF CREDIT RISKS**

Financial instruments that potentially subject the Group to concentrations of credit risk consist principally of cash and cash equivalents and trade receivables.

The majority of the Group's cash and cash equivalents and deposits are invested in dollar instruments with major banks in Israel and in the U.S. Management believes that the financial institutions that hold the Group investments are financially sound and accordingly, minimal credit risk exists with respect to these investments.

The Group's trade receivables are derived primarily from sales to large and solid customers and governments located mainly in Israel, the United States and Europe. The Group performs ongoing credit evaluations of its customers and to date, has not experienced any unexpected material losses except for a one time loss in 2002 of approximately $4,600 due to the insolvency of one of the Group's customers. An allowance for doubtful accounts is determined with respect to those amounts that the Group has determined to be doubtful of collection.

## *Note 2 – SIGNIFICANT ACCOUNTING POLICIES (Cont.)*

**T. DERIVATIVE FINANCIAL INSTRUMENTS**

Financial Accounting Standards Board Statement No. 133, Accounting for Derivative Instruments and Hedging Activities ("SFAS No. 133"), requires companies to recognize all of its derivative instruments as either assets or liabilities in the statement of financial position at fair value. The accounting for changes in the fair value (i.e. gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship. For those derivative instruments that are designated and qualify as hedging instruments, a company must designate the hedging instrument, based upon the exposure being hedged, as a fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operations.

For derivative instruments that are designated and qualify as a fair value hedge (i.e., hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk), the gain and loss on the derivative instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in the same line item associated with the hedged item in current earnings during the period of the change in fair values. For derivative instruments that are designated and qualify as a cash flow hedge (i.e. hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income and reclassified into earnings in the same line item associated with the forecasted transaction in the same period or periods during which the hedged transaction affects earnings.

The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item, if any, is recognized in other income/expense in current earnings during the period of change.

For derivative instruments not designated as hedging instruments, the gain or loss is recognized in other income/expense in current earnings during the period of change.

As part of its fair value hedging strategy the Group enters into forward exchange contracts to hedge certain firm commitments denominated in foreign currencies. The purpose of the Group's foreign currency hedging activities is to protect the Group from risk that the eventual dollar cash flows from the sale of products to international customers will be adversely affected by changes in the exchange rates.

In addition, in order to ensure the dollar value of certain assets and liabilities, the Group enters into forward exchange contracts.

As part of its cash flows hedging strategy the Group enters into forward exchange contracts to hedge forecasted salary expenses denominated in currency other than the U.S. dollar.

As of December 31, 2003, the Group had forward contracts with notional value of approximately $27,500 to purchase and sell foreign currencies. The Group also had options to hedge future cash flow in the amount of $24,000. The forward contracts and the options mature in 2004.

The fair value of the foreign exchange contracts as of December 31, 2003 amounted to $1,113. The fair value of the options as of December 31, 2003 is minimal.

## *Note 2 – SIGNIFICANT ACCOUNTING POLICIES (Cont.)*

**U. STOCK-BASED COMPENSATION**

The Company has elected to follow Accounting Principles Board Opinion No. 25 ("APB No. 25") "Accounting for Stock Issued to Employees" and FASB Interpretation No. 44 ("FIN No. 44") "Accounting for Certain Transactions Involving Stock Compensation" in accounting for its employee stock option plans. Under APB No. 25, compensation expense is recognized based on the intrinsic value method where by compensation expense is equal to the excess if any of the quoted market price of the stock at the grant date of the award or other measurement date, over the amount an employee must pay to acquire the stock. The Company recognizes the expense over the vesting period of the award.

In respect of phantom share options, the Company applies variable stock compensation accounting (See Note 17C).

The Company adopted the disclosure provisions of Financial Accounting Standards Board Statement No. 148, "Accounting for Stock-Based Compensation – transition and disclosure" ("SFAS No. 148"), which amended certain provisions of SFAS No. 123, "Accounting for Stock-Based Compensation", to provide alternative methods of transition for an entity that voluntarily changes the fair value based method of accounting for stock-based employee compensation, effective as of the beginning of the fiscal year. The Company continues to apply the provisions of APB No. 25, in accounting for stock-based compensation.

Pro forma information regarding the Company's net income and net earnings per share is required by SFAS No. 123 and has been determined as if the Company had accounted for its employee stock options under the fair value method prescribed by SFAS No. 123.

The fair value for options granted in 2003, 2002 and 2001 is amortized over their vesting period and estimated at the date of grant using a Black-Scholes options pricing model with the following weighted average assumptions:

| | 2003 | 2002 | 2001 |
|---|---|---|---|
| Divided yield | 2.19% | 1.99% | 2.03% |
| Expected volatility | 19.03% | 21.9% | 33.8% |
| Risk-free interest | 1.20% | 1.34% | 2% |
| Expected life of up to | 6 years | 6 years | 6 years |

## *Note 2 – SIGNIFICANT ACCOUNTING POLICIES (Cont.)*

**U. STOCK-BASED COMPENSATION (Cont.)**

Pro forma informatiom under SFAS 123 is as follows:

| | Year ended December 31 | | |
|---|---|---|---|
| | **2003** | **2002** | **2001** |
| Net income as reported | $ 45,945 | $ 45,113 | $ 40,796 |
| Add – Stock based compensation expense (income), net of related tax effects as reported (intrinsic method) | 3,793 | (741) | 6,810 |
| Deduxt – Stock based compensation expense under fair value based method of SFAS 123 net of related tax effects | (2,956) | (2,956) | (2,932) |
| **Pro forma net income** | **$ 46,782** | **$ 41,416** | **$ 44,674** |
| Net earnings per share: | | | |
| **Basic net earnings per share as reported** | **$ 1.18** | **$ 1.17** | **$ 1.07** |
| **Diluted net earnings per share as reported** | **$ 1.14** | **$ 1.13** | **$ 1.04** |
| **Pro forma basic net earnings per share** | **$ 1.20** | **$ 1.08** | **$ 1.18** |
| **Pro forma diluted net earnings per share** | **$ 1.16** | **$ 1.04** | **$ 1.14** |

**V. FFAIR VALUE FINANCIAL INSTRUMENTS**

The carrying amount reported in the balance sheet for cash and cash equivalents, short-term bank deposits, trade receivables, short-term bank credit and loans and trade payables approximate their fair values due to the short-term maturities of such instruments.

Long-term loans are estimated by discounting the future cash flows using current interest rates for loans of similar terms and maturities. The carrying amount of the long-term loans approximates their fair value.

The fair value of foreign currency contracts (used for hedging purposes) is estimated by obtaining current quotes from investment bankers.

It was not practicable to estimate the fair value of the Group's investments in shares of non-public companies that are accounted for under the cost method because of the lack of a quoted market price and the inability to obtain valuation of each company without incurring excessive costs. The carrying amounts of these companies were $11,104 and $11,745 as of December 31, 2002 and 2003, respectively, and represent the original cost of acquisition.

## *Note 2 – SIGNIFICANT ACCOUNTING POLICIES (Cont.)*

**W. BASIC AND DILUTED NET EARNINGS PER SHARE**

Basic net earnings per share is computed based on the weighted average number of Ordinary shares outstanding during each year. Diluted net earnings per share is computed based on the weighted average number of Ordinary shares outstanding during each year, plus dilutive potential Ordinary shares considered outstanding during the year in accordance with SFAS No. 128 "Earnings Per Share". Outstanding stock options are excluded from the calculation of the diluted net earnings per Ordinary share when such securities are anti-dilutive. In all the years presented no stock options were excluded.

**X. IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS**

In November 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34" ("FIN No. 45"). FIN No. 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee.

FIN No. 45 does not prescribe a specific approach for subsequently measuring the guarantor's recognized liability over the term of the related guarantee. It also incorporates, without change, the guidance in FASB Interpretation No.34, "Disclosure of Indirect Guarantees of Indebtedness of Others", which is being superseded. The disclosure provisions of FIN No. 45 are effective for financial statements of interim or annual periods that end after December 15, 2002, and the provisions for initial recognition and measurement are effective on a prospective basis for guarantees that are issued or modified after December 31, 2002, irrespective of a guarantor's year-end. The adoption of FIN No. 45 did not have a material impact on the Group's results of operations or financial position.

In November 2002, the EITF reached a consensus on Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables". EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 applied to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Additionally, companies will be permitted to apply the consensus guidance in this issue to all existing arrangements as the cumulative effect of a change in accounting principle in accordance with APB Opinion No. 20, "Accounting Changes". The adoption of EITF Issue No. 00-21 did not have a material impact upon the Company's consolidated financial position, cash flows or results of operations.

In December 2003, the SEC issued Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition." ("SAB No. 104") which revises or rescinds certain sections of SAB No. 101, "Revenue Recognition", in order to make this interpretive guidance consistent with current authoritative accounting and auditing guidance and SEC rules and regulations. The changes noted in SAB NO. 104 did not have a material effect on the Company's consolidated financial position, results of operations or cash flows.

## *Note 2 – SIGNIFICANT ACCOUNTING POLICIES (Cont.)*

**X. IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS (Cont.)**

In 2003, the FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin No. 51 ("FIN 46"). In December 2003, the FASB revised FIN 46 to make certain technical corrections and address certain implementation issues that had arisen. FIN 46 provides a new framework for identifying Variable Interest Entities ("VIE's") and determining when a company should include the assets, liabilities, non-controlling interests and results of activities of a VIE in its consolidated financial statements.

In general, a VIE is an entity that either (1) has an insufficient amount of equity to carry out its principal activities, without additional subordinated financial support, (2) has a group of equity owners that are unable to make significant decisions about the entity's activities, or (3) has a group of equity owners that do not have the obligation to absorb the entity's losses or the right to receive returns generated by its operations. FIN 46 requires the consolidation of a VIE by the primary beneficiary. The primary beneficiary is the entity that absorbs a majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity.

The Group is currently evaluating the effects of this interpretation in respect of its investments. It is possible that some of its unconsolidated investees may be considered as VIEs in accordance with the interpretation. Accordingly, if it is determined that the Group is the primary beneficiary of a VIE, the Group will be required to consolidate the financial statements of such VIE with its own financial statements commencing in the first quarter of 2004.

**Y. RECLASSIFICATIONS**

Certain financial statement data for prior years has been reclassified to conform with current year financial statement presentation.

## *Note 3 – TRADE RECEIVABLES, NET*

**Trade receivables**

| | December 31 | |
|---|---|---|
| | **2003** | **2002** |
| Open accounts (*) | $170,287 | $185,997 |
| Unbilled receivables | 36,855 | 43,187 |
| Less - allowance for doubtful accounts | (3,861) | (3,411) |
| | **$203,281** | **$225,773** |
| ***(*)* Includes affiliated companies** | **$6,668** | **$9,647** |

## *Note 4 – OTHER RECEIVABLES AND PREPAID EXPENSES*

| | December 31 | |
|---|---|---|
| | **2003** | **2002** |
| Prepaid expenses | $ 14,310 | $ 12,244 |
| Government departments | 5,826 | 5,915 |
| Employees | 513 | 1,029 |
| Deferred income taxes | 21,908 | 19,997 |
| Others | 5,806 | 3,513 |
| | **$ 48,363** | **$ 42,698** |

## *Note 5 – INVENTORIES, NET OF ADVANCES*

| | December 31 | |
|---|---|---|
| | **2003** | **2002** |
| Cost incurred on long-term contracts in progress | $ 253,663 | $ 210,418 |
| Raw materials | 78,504 | 75,579 |
| Advances to suppliers and subcontractors | 20,137 | 25,047 |
| | **352,304** | **311,044** |
| Less - | | |
| Cost incurred on contracts in progress deducted from customer advance | 14,581 | 10,658 |
| | **337,723** | **300,386** |
| Less - | | |
| Advances received from customers | 77,482 | 67,624 |
| Provision for losses | 11,016 | 12,363 |
| | **$ 249,225** | **$ 220,399** |

The Company has transferred legal title of inventories to certain customers as collateral for advances received.

## *Note 6 – INVESTMENTS IN AFFILIATED COMPANIES, PARTNERSHIP AND OTHER COMPANIES*

**A. Investments in companies accounted for under the equity method:**

| | December 31 | |
|---|---|---|
| | **2003** | **2002** |
| SCD (1) | $ 17,347 | $ 15,713 |
| VSI (2) | 6,149 | 3,893 |
| Opgal (3) | 2,390 | 2,028 |
| Others (4) | 592 | 313 |
| | **$ 26,478** | **$ 21,947** |

**(1)** Semi Conductor Devices ("SCD"), an Israeli partnership, held 50% by the Company and 50% by Rafael Armaments Development Authority Ltd. ("Rafael"). SCD is engaged in the development and production of various thermal detectors and laser diodes. SCD is jointly controlled and therefore is not consolidated in the Company's financial statements.

**(2)** Vision Systems International LLC ("VSI") based in San Jose, is a California limited liability company that is held 50% by EFW. VSI is jointly controlled and therefore is not consolidated in the Company's financial statements. VSI operates in the area of helmet mounted display systems for fixed wing military and paramilitary aircraft.

**(3)** Opgal Optronics Industries Ltd. ("Opgal") is an Israeli company owned 50.1% by the Company and 49.9% by a subsidiary of Rafael. Opgal focuses mainly on commercial applications of thermal imaging and electro-optic technologies. The Company jointly controls Opgal with Rafael, and therefore Opgal is not consolidated in the Company's financial statements.

**(4)** Mediguide Inc. ("Mediguide") and its Israeli subsidiary, Mediguide Ltd., were established in 2000 as a spin-off from the Company, which holds the majority of Mediguide's Ordinary shares. In 2001-2003, Mediguide issued Preferred shares to other investors in consideration for approximately $16,000. The Preferred shares entitle the other investors to preference rights in any liquidation event. Therefore, the Company did not record any gain as a result of the above transaction. In addition the Preferred shares entitle their holders to certain participating rights. Accordingly, based on the guidance in EITF 96-16, the Company does not consolidate Mediguide. The carrying value of the investment in Mediguide is zero.

RedC Optical Networks Inc. ("RedC") is engaged in the multi-focal optic communications sector and is held 36.5% by El-Op. RedC designs, develops and manufacture optical amplifiers for dense wave-length multiplexing (DWDM) optical networks for telecommunication renders. Based on analysis performed, the Company recorded a provision for loss on its investment in RedC of $2,500 during the year ended December 31, 2002. This provision has been presented under "Equity in net earnings of affiliated companies and partnership".

**(5)** See Note 16(E) for guarantees.

## *Note 6 – INVESTMENTS IN AFFILIATED COMPANIES, PARTNERSHIP AND OTHER COMPANIES (Cont.)*

**B. Investments in companies accounted for under the cost method**

| | December 31 | |
|---|---|---|
| | **2003** | **2002** |
| Soltam (1) | $ 3,500 | $ 3,500 |
| ISI (2) | 7,230 | 7,230 |
| Aero Astro (3) | 1,000 | - |
| Other | 15 | 374 |
| | **$ 11,745** | **$ 11,104** |

**(1)** Soltam Systems Ltd. ("Soltam"), held 10%, is an Israeli company engaged in the development and manufacturing of military systems in the artillery sector.

**(2)** ImageSat International N.V. ("ISI"), held 14% (10% on a fully diluted basis), is engaged in the operation of satellite photography formations and commercial delivery of satellite photography for civil purposes.

**(3)** AeroAstro Inc. - In October 2003, the Company purchased Common stock of AeroAstro Inc., ("AAI") a Delaware corporation, representing 8.33% of the total outstanding Common stock of AAI on a fully diluted basis, in consideration for $1,000. AAI is engaged in innovative micro and nanospacecraft applications. AAI manufactures low-cost satellite systems and components, used in its own spacecraft and for spacecraft development in and outside the U.S.

## *Note 7 – LONG –TERM BANK DEPOSITS AND LOAN*

| | December 31 | |
|---|---|---|
| | **2003** | **2002** |
| Deposits with bank for loans granted to employees (*) | $ 1,901 | $ 2,037 |
| Other deposits with bank | 53 | 935 |
| Long-term loan | - | 714 |
| | **$ 1,954** | **$ 3,686** |

* The deposits are linked to the Israeli CPI, bear annual interest of 4% and are presented net of current maturities of $633 (2002 - $680).

## *Note 8 – PROPERTY, PLANT AND EQUIPMENT, NET*

| | December 31 | |
|---|---|---|
| | **2003** | **2002** |
| **COST (1):** | | |
| Land, buildings and leasehold improvements (2) | $ 143,223 | $ 128,456 |
| Instruments, machinery and equipment (3) | 194,129 | 169,467 |
| Office furniture and other | 24,943 | 21,904 |
| Motor vehicles | 29,776 | 24,393 |
| | **392,071** | **344,220** |
| Accumulated depreciation | (162,850) | (141,259) |
| **Depreciated cost** | **$ 229,221** | **$ 202,961** |

Depreciation expenses for the years ended December 31, 2003, 2002 and 2001 amounted to $30,775, $26,525 and $24,517, respectively.

**(1)** Net of investment grants received (mainly for instruments, machinery and equipment) in the amounts of approximately $30,700 and $30,800 as of December 31, 2003 and 2002, respectively.

**(2)** Includes, rights in approximately 9,225 square meters of land in, Tirat Hacarmel, Israel. The land is leased from the Israel Land Administration until the years 2014 to 2024 with a renewal option for additional periods of up to 49 years. The Company's rights in the land have not yet been registered in its name.

Includes, rights in approximately 10,633 square meters of land in Rehovot, Israel. The land is leased from the Israel Land Administration until the year of 2043 with a renewal option for additional periods of up to 49 years. The Company's rights in the land have not yet been registered in its name.

**(3)** Includes equipment produced by the Group for its own use in the amount of $10,498 and $5,517 as of December 31, 2003 and 2002, respectively.

**(4)** As for pledges of assets - see Note 16(H).

## *Note 9 – OTHER ASSETS, NET*

**A.**

| | Weighted-average number of years | December 31 | |
|---|---|---|---|
| | | 2003 | 2002 |
| **Original cost:** | | | |
| Know-how and technology (1) | 12.5 | $ 82,449 | $ 81,398 |
| Trade marks (2) | 17 | 8,000 | 8,000 |
| Goodwill (3) | | 37,613 | 37,199 |
| | | **128,062** | **126,597** |
| **Accumulated amortization:** | | | |
| Know-how and technology | | 21,555 | 14,666 |
| Trade marks | | 1,458 | 1,125 |
| Goodwill | | 5,037 | 5,037 |
| | | **28,050** | **20,828** |
| **Amortized cost** | | **$ 100,012** | **$ 105,769** |

**(1)** Includes mainly know-how acquired in the merger with El-Op ($45,000), know-how acquired in the acquisition of AEL and the Government Division ($10,600) and intangible assets acquired from Honeywell Inc. ($9,300).

**(2)** Includes trade marks acquired in the merger with El-Op.

**(3)** Includes mainly goodwill acquired in the merger with El-Op ($34,200) and goodwill acquired from Honeywell Inc. ($1,800). Until January 1, 2002, goodwill was amortized at an annual rate of 5% - 10%.

**B.** Amortization expenses amounted to $7,222, $6,412 and $8,348 for the years ended December 31, 2003, 2002 and 2001, respectively.

**C.** The annual amortization expense relating to intangible assets existing as of December 31, 2003 for each of the five years in the period ending December 31, 2008 is estimated to be approximately $6,000.

## *Note 9 – OTHER ASSETS, NET (Cont.)*

The following information is presented to reflect net income and net earnings per share for all prior periods adjusted to exclude amortization of goodwill.

| | Year ended December 31, |
|---|---|
| | **2001** |
| Reported net income | $ 40,796 |
| Goodwill amortization | 2,760 |
| **Adjusted net income** | **$ 43,556** |
| | |
| Net earnings per share | |
| Reported basic net earnings per share | $ 1.07 |
| Goodwill amortization | 0.08 |
| **Adjusted basic net earnings per share** | **$ 1.15** |
| | |
| Reported diluted net earnings per share | $ 1.04 |
| Goodwill amortization | 0.07 |
| **Adjusted diluted net earnings per share** | **$ 1.11** |

## *Note 10 – SHORT-TERM BANK CREDIT AND LOANS*

| | December 31 | | | |
|---|---|---|---|---|
| | **2003** | **2002** | **2003** | **2002** |
| | **Interest rate %** | | | |
| **Short-term bank loans:** | | | | |
| In U.S. dollars | 3.3-4.75 | 3-5 | $ 533 | $ 13,512 |
| In EURO | 3.5 | - | 1,927 | - |
| | | | **2,460** | **13,512** |
| **Short-term bank credit:** | | | | |
| In NIS unlinked | 7.2 | 9.6-10.9 | 4,684 | 5,241 |
| In U.S. dollars | 2.6 | 2.8-3.6 | 1,365 | 5,549 |
| | | | **6,049** | **10,790** |
| | | | **$ 8,509** | **$ 24,302** |

The subsidiary in the U.S. maintains standby lines of credit with various banks. The sum of the lines equals $66,000 of which $15,900 was available as of December 31, 2003.

As for liens – see Note 16(F).

### *Note 11 – OTHER PAYABLES AND ACCRUED EXEPNSES*

| | December 31 | |
|---|---|---|
| | **2003** | **2002** |
| Payroll and related expenses | $ 33,382 | $ 27,912 |
| Provision for vacation pay | 25,280 | 20,492 |
| Government departments | 25,243 | 22,443 |
| Provision for warranty | 9,692 | 8,541 |
| Cost provisions and others | 62,930 | 61,916 |
| | **$ 156,527** | **$ 141,304** |

### *Note 12 – CUSTOMERS ADVANCES AND AMOUNTS IN EXCESS OF COSTS INCURRED ON CONTRACTS IN PROGRESS*

| | December 31 | |
|---|---|---|
| | **2003** | **2002** |
| Advances received | $ 199,273 | $ 225,160 |
| Less - | | |
| Advances presented under long-term liabilities | 7,592 | 40,411 |
| Advances deducted from inventories | 77,482 | 67,624 |
| | **114,199** | **117,125** |
| Less - | | |
| Costs incurred on contracts in progress | 14,581 | 10,658 |
| | **$ 99,618** | **$ 106,467** |

As for guarantees see Note 16(G).

### *Note 13 – LONG-TERM LOANS*

| | | Interest | Years of | December 31 | |
|---|---|---|---|---|---|
| | **Linkage** | **%** | **maturity** | **2003** | **2002** |
| Banks | U.S. dollars | Libor + 0.75%-1.85% | 2004 – 2005 | $ 57,574 | $ 67,206 |
| Banks | NIS-unlinked | Israeli Prime | 2004 – 2022 | 3,599 | 3,383 |
| Office of Chief Scientist | NIS-linked to the Israeli-CPI | 5.2% | 2004 – 2008 | 7,683 | 9,197 |
| | | | | **68,856** | **79,786** |
| Less-current maturities | | | | 6,818 | 6,613 |
| | | | | **$62,038** | **$ 73,173** |

## *Note 13 – LONG-TERM LOANS (Cont.)*

The Libor rate as of December 31, 2003 was 1.12%.

The Israeli Prime rate as of December 31, 2003 was 6.3%.

The maturities of these loans after December 31, 2003 are as follows:

| | |
|---|---|
| 2004 – current maturities | $ 6,818 |
| 2005 | 56,136 |
| 2006 | 2,693 |
| 2007 | 139 |
| 2008 | 148 |
| 2009 and thereafter | 2,922 |
| | **$ 68,856** |

In connection with bank credits and loans, including performance guarantees issued by banks and bank guarantees securing certain advances from customers, the Company and certain subsidiaries are obligated to meet certain loan covenants. Management believes that the Company and the subsidiaries meet the conditions of these covenants as of balance sheet date.

As for charges see Note 16(H).

## *Note 14 – BENEFIT PLANS*

The subsidiary in the U.S. has adopted for its employees in the U.S. benefits plans as follows:

**Defined Benefit Retirement Plan**

The subsidiary in the U.S. has two defined benefit pension plans (the Plans) covering substantially its employees in the U.S. Monthly benefits are based on years of benefit service and annual compensation. Annual contributions to the Plans are determined using the unit credit actuarial cost method and are equal to or exceed the minimum required by law. Pension fund assets of the Plans are invested primarily in stock, bonds and cash by a financial institution, as the investment manager of the Plans' assets.

The following table reconciles the benefit obligations, Plans assets, funded status and net asset (liability) information of the Plans:

## *Note 14 – BENEFIT PLANS (Cont.)*

| | December 31 | |
|---|---|---|
| | **2003** | **2002** |
| Benefit obligation at beginning of year | $ 28,439 | $22,358 |
| Service cost | 2,480 | 2,067 |
| Interest cost | 1,921 | 1,678 |
| Actuarial losses | 2,825 | 2,955 |
| Benefits repaid | (700) | (619) |
| **Benefit obligation at end of year** | **34,965** | **28,439** |
| Plans assets at beginning of year | 15,558 | 16,167 |
| Actual return on Plan assets | 2,689 | (1,560) |
| Contributions by employer | 3,649 | 1,571 |
| Benefits repaid | (700) | (619) |
| **Plans assets at end of year** | **21,196** | **15,559** |
| Funded status of Plans (underfunded) | (13,769) | (12,880) |
| Unrecognized prior service cost | (195) | 234 |
| Unrecognized net actuarial loss | 9,395 | 7,582 |
| **Net amount recognized** | **(4,569)** | **(5,064)** |
| Net asset (liability) consists of: | | |
| Accrued benefit liability | (11,011) | (10,298) |
| Intangible asset | 51 | 234 |
| Accumulated other comprehensive income | 6,391 | 5,000 |
| **Net amount recognized** | **(4,569)** | **(5,064)** |
| Weighted average assumptions : | | |
| Discount rate as of December 31, | 6.25% | 6.75% |
| Expected long-term rate of return on Plans assets | 9.00% | 9.00% |
| Rate of compensation increase | 3.00% | 3.00% |

| | Year ended December 31 | | |
|---|---|---|---|
| | **2003** | **2002** | **2001** |
| **Components of net periodic pension cost:** | | | |
| Service cost | $ 2,480 | $ 2,067 | $ 1,766 |
| Interest cost | 1,921 | 1,678 | 1,461 |
| Expected return on Plan assets | (1,573) | (1,597) | (1,666) |
| Amortization of prior service cost | (15) | 28 | 24 |
| Recognized of net actuarial gain | 339 | - | (38) |
| One-time FAS 88 charge for 2001 SRP | - | - | 177 |
| **Net periodic pension cost** | **$ 3,152** | **$ 2,176** | **$ 1,724** |

## *Note 14 – BENEFIT PLANS (Cont.)*

**Defined Contribution Plan**

The 401(k) savings plan ("401(k) plan") is a defined contribution retirement plan that covers all eligible employees, as defined in section 401(k) of the U.S. Internal Revenue Code. Subsidiary's employees may elect to contribute a percentage of their annual gross compensation to the 401(k) plan. The U.S. subsidiary may make discretionary matching contributions as determined by the subsidiary. Total expense under the 401(k) plan amounted to $1,629 for the year ended December 31, 2003 (2002 - $1,369).

## *Note 15 – TAXES ON INCOME*

**A. APPLICABLE TAX LAWS**

**(1) Measurement of taxable income under Israel's Income Tax (Inflationary Adjustments) Law, 1985:**

Results for tax purposes for the Company and certain of its Israeli subsidiaries are measured and reflected in accordance with the change in the Israeli Consumer Price Index ("CPI"). As explained above in Note 2B, the consolidated financial statements are presented in U.S. dollars. The differences between the change in the Israeli CPI and in the NIS/U.S. dollar exchange rate cause a difference between taxable income and the income before taxes reflected in the consolidated financial statements.

In accordance with paragraph 9(f) of SFAS No. 109, the Company has not provided deferred income taxes on the above difference between the reporting currency and the tax basis of assets and liabilities.

**(2) Tax benefits under Israel's Law for the Encouragement of Industry (Taxes), 1969:**

The Company and certain subsidiaries in Israel (mainly El-Op and Cyclone) are "Industrial Companies", as defined by the Law for the Encouragement of Industry (Taxes), 1969, and as such, these companies are entitled to certain tax benefits, mainly amortization of costs relating to know-how and patents over eight years, accelerated depreciation and the right to deduct public issuance expenses for tax purposes.

**(3) Tax benefits under Israel's Law for the Encouragement of Capital Investments, 1959:**

Several expansion programs of the Company and certain of its Israeli subsidiaries ("the companies") have been granted "Approved Enterprise" status under Israel's Law for the Encouragement of Capital Investments, 1959. For some expansion programs, the companies have elected the grants track and for others they have elected the alternative tax benefits track, waiving grants in return for tax exemptions.

Accordingly, certain income of the companies, derived from the "Approved Enterprise" expansion programs is tax exempt for two-year to ten-year period and subject to reduced tax rates of 25% for a five-year to eight-year period commencing in the year in which the companies had taxable income (limited to twelve years from commencement of production or fourteen years from the date of approval, whichever is earlier). As of December 31, 2003, the tax benefits for these expansion programs will expire between 2004 to 2010.

## *Note 15 – INCOME TAXES (Cont.)*

### A. APPLICABLE TAX LAWS (Cont.)

#### (3) Tax benefits under Israel's Law for the Encouragement of Capital Investments, 1959: (Cont.)

The entitlement to the above benefits is subject to the companies fulfilling the conditions specified in the above referred law, regulations published there under and the letters of approval for the specific investments in "Approved Enterprises". In the event of failure to comply with these conditions, the benefits may be canceled and the companies may be required to refund the amount of the benefits, in whole or in part, including interest. (For liens – see Note 16F). As of December 31, 2003, Management believes that the companies are meeting all conditions of the approvals.

The tax-exempt income attributable to the "Approved Enterprise" can be distributed to shareholders without imposing tax liability on the companies only upon the complete liquidation of the companies. As of December 31, 2003, retained earnings included approximately $96,000 in tax-exempt profits earned by the companies' "Approved Enterprise".

If the retained tax-exempt income is distributed in a manner other than on the complete liquidation of the Company, it would be taxed at the corporate tax rate applicable to such profits as if the Company had not elected alternative tax benefits (currently - 25%) and an income tax liability would be incurred of approximately $ 23,940 as of December 31, 2003.

The Company's Board of Directors has decided that its policy is not to declare dividends out of such tax-exempt income. Accordingly, no deferred income taxes have been provided on income attributable to the Companies "Approved Enterprise".

In Israel, income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 36%.

Since the companies are operating under more than one approval, and since part of their taxable income is not entitled to tax benefits under the abovementioned law and is taxed at the regular tax rate of 36%, the effective tax rate is the result of a weighted combination of the various applicable rates and tax exemptions, and the computation is made for income derived from each approval on the basis of formulas specified in the law and in the approvals.

### B. NON-ISRAELI SUBSIDIARIES

Non-Israeli subsidiaries are taxed based on tax laws in their countries of residence (mainly in the U.S.)

## *Note 15 – INCOME TAXES (Cont.)*

### C. INCOME (LOSS) BEFORE TAXES ON INCOME

| | Year ended December 31 | | |
|---|---|---|---|
| | **2003** | **2002** | **2001** |
| **Income before taxes on income income:** | | | |
| Domestic | $ 38,423 | $42,317 | $44,212 |
| Foreign | 11,090 | 11,977 | 7,638 |
| | **$49,513** | **$54,294** | **$51,850** |

### D. TAXES ON INCOME

| | | | |
|---|---|---|---|
| **Taxes on income:** | | | |
| ***Current taxes:*** | | | |
| Domestic | $ 12,346 | $ 11,654 | $ 9,385 |
| Foreign | 718 | 6,114 | 3,048 |
| | **$ 13,064** | **17,768** | **12,433** |
| ***Deferred income taxes:*** | | | |
| Domestic | (4,672) | (3,561) | (839) |
| Foreign | 2,942 | (2,059) | (591) |
| | **(1,730)** | **(5,620)** | **(1,430)** |
| Taxes in respect of prior years | - | (*)(2,800) | - |
| | **$ 11,334** | **$ 9,348** | **$ 11,003** |

(*) A reduction of tax expenses due to adjustments of estimated tax provision pursuant to the completion of prior years' tax assessments in respect of various Group companies.

### E. DEFERRED INCOME TAXES

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of net deferred tax assets and liabilities are as follows:

## *Note 15 – INCOME TAXES (Cont.)*

**E. DEFERRED INCOME TAXES (Cont.)**

| | | Deferred tax asset (liability) (1) | |
|---|---|---|---|
| | **Total** | **Current** | **Non-current** |
| **As of December 31, 2003** | | | |
| ***Deferred tax assets:*** | | | |
| Reserve and allowances | $13,884 | $13,922 | $(38) |
| Inventory | 7,547 | 7,547 | - |
| Net operating loss carryforwards | 6,606 | 439 | 6,167 |
| | **28,037** | **21,908** | **6,129** |
| Valuation allowance (2) | (3,879) | - | (3,879) |
| **Net deferred tax assets** | **24,158** | **21,908** | **2,250** |
| ***Deferred tax liabilities:*** | | | |
| Property, plant and equipment | (12,769) | - | (12,769) |
| Other assets | (14,397) | - | (14,397) |
| | **(27,166)** | **-** | **(27,166)** |
| **Net deferred tax assets (liabilities)** | **$ (3,008)** | **$ 21,908** | **$ (24,916)** |
| **As of December 31, 2002** | | | |
| ***Deferred tax assets:*** | | | |
| Reserve and allowance | $10,510 | $10,859 | $(349) |
| Inventory | 9,138 | 9,138 | - |
| Net operating loss carryforwards | 2,326 | - | 2,326 |
| | **21,974** | **19,997** | **1,977** |
| Valuation allowance (2) | (2,326) | - | (2,326) |
| **Net deferred tax assets** | **19,648** | **19,997** | **(349)** |
| ***Deferred tax liabilities:*** | | | |
| Property, plant and equipment | (9,209) | - | (9,209) |
| Other assets | (15,177) | - | (15,177) |
| | **(24,386)** | **-** | **(24,386)** |
| **Net deferred tax assets (liabilities)** | **$ (4,738)** | **$19,997** | **$ (24,735)** |

(1) Current tax asset is included in other receivables. Noncurrent tax liability is included as a long-term liability.

(2) During 2003, the Group increased the valuation allowance due to an increase in accumulated operating loss carryforwards that more likely than not, will not be utilized.

## *Note 15 – INCOME TAXES (Cont.)*

**F.** The Group's Israeli subsidiaries have estimated total available carryforward tax losses of approximately $12,000 as of December 31, 2003. The Group's non-Israeli subsidiaries have estimated available carryforward tax losses of approximately $8,500 as of December 31, 2003 to offset against future taxable profits for an indefinite period. Deferred tax assets in respect of the above carryforward losses amount to approximately $6,600 in respect of which a valuation allowance has been recorded in the amount of approximately $3,900.

**G.** Reconciliation of the theoretical tax expense, assuming all income is taxed at the statutory rate applicable to income of the Group, and the actual tax expense as reported in the statements of operations, is as follows:

| | Year ended December 31 | | |
|---|---|---|---|
| | **2003** | **2002** | **2001** |
| Income before taxes as reported in the consolidated statements of operations | $ 49,513 | $54,294 | $51,850 |
| Statutory tax rate | 36% | 36% | 36% |
| Theoretical tax expense | $ 17,825 | $19,546 | $18,666 |
| Tax benefit arising from reduced rate as an "Approved Enterprise" and other tax benefits | (8,391) | (9,054) | (7,697) |
| Tax adjustment in respect of different tax rate for foreign subsidiaries | 279 | (461) | (952) |
| Operating carryforward losses for which valuation allowance was provided | 126 | 2,189 | 101 |
| Increase (decrease) in taxes resulting from nondeductible expenses | 993 | (263) | 571 |
| Difference in basis of measurement for financial reporting and tax return purposes | 846 | 458 | 832 |
| Taxes in respect of prior year | - | (2,800) | - |
| Other differences, net | (344) | (267) | (518) |
| **Actual tax expenses** | **$11,334** | **$9,348** | **$11,003** |
| **Effective tax rate** | **22.9%** | **17.2%** | **21.2%** |

## *Note 16 – COMMITMENTS AND CONTINGENT LIABILITIES*

### A. ROYALTY COMMITMENTS

1. The Company and certain Israeli subsidiaries partially finance their research and development expenditures under programs sponsored by the Office of the Chief Scientist in Israel ("OCS") for the support of research and development activities conducted in Israel. At the time the participations were received, successful development of the related projects was not assured.

   In exchange for participation in the programs by the OCS, the Company and the subsidiaries agreed to pay 2% - 5% of total sales of products developed within the framework of these programs. The royalties will be paid up to maximum amount equaling 100% to 150% of the grants provided by the OCS, linked to the dollar and for grants received after January 1, 1999, also bearing annual interest at a rate based on LIBOR and other applicable law. The obligation to pay these royalties is contingent on actual sales of the products and in the absence of such sales, payment of royalties is not required.

   In some cases, the Government of Israel participation (through the OCS) is subject to export sales or other conditions. The maximum amount of royalties is increased in the event of production outside of Israel.

   The Company and certain of its subsidiaries are also obligated to pay certain amounts to the Israeli Ministry of Defense and others on certain sales including sales resulting from the development of certain technology.

   Royalties expensed or accrued amounted to $7,812, $14,741 and $8,252 in 2003, 2002 and 2001, respectively.

2. In September 2001, the OCS issued "Regulations for the Encouragement of Research and Development in Industry" (rules for determining the level and payment of royalties) ("the regulations"). The regulations allow large R&D intensive companies to reach certain agreements with the OCS regarding determination of the amount and payment schedule of royalties, subject to certain conditions.

   If the Company elects to adopt the regulations, it will have to record a significant one-time expense resulting from accruing a liability for an absolute amount of royalties.

   In May 2002, El-Op's Board of Directors approved an arrangement, proposed by the OCS, according to which El-Op pays commencing in 2002, an agreed amount of $10,632 in exchange for a release from all obligations to pay royalties in the future. As a result El-Op recorded an expense for the agreed amount net of the accrual for royalties previously recorded by El-Op in the amount of $9,801 included in Cost of Revenues.

## *Note 16 – COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)*

### B. COMMITMENTS IN RESPECT OF LONG-TERM PROJECTS

In connection with long-term projects in certain countries, the Company and certain subsidiaries undertook to use their respective best efforts to make or facilitate purchases or investments in those countries at certain percentages of the amount of the projects. The companies' obligation to make or facilitate third parties making such investments and purchases is subject to commercial conditions in the local market, typically without a specific financial penalty. The maximum aggregate undertaking as of December 31, 2003 amounted to $630,000 to be performed over a period of up to 11 years, is typically tied to a percentage (up to 100%) of the amount of the specific contract.

In the opinion of Management, the actual amount of the investments and purchases is anticipated to be less than that mentioned above, since certain investments and purchases can result in reducing the overall undertaking on more than a one to one basis.

### C. LEGAL CLAIMS

The Company and its subsidiaries are involved in legal claims arising in the ordinary course of business, including claims by employees, consultants and others. Company's Management, based on the opinion of its legal counsel, believes that the financial impact for the settlement of such claims in excess of the accruals recorded in the financial statements will not have a material adverse effect on the financial position or results of operations of the Group.

### D. LEASE COMMITMENTS

The future mininum lease commitments of the Group under various non-cancelable operating lease agreements in respect of premises, motor vehicles and office equipment are as of December 31, 2003:

| | |
|---|---|
| 2004 | $8,520 |
| 2005 | 6,145 |
| 2006 | 5,557 |
| 2007 | 5,453 |
| 2008 and thereafter | 5,451 |
| | **$ 31,126** |

Rent expenses for the years ended December 31, 2003, 2002 and 2001 amounted to $9,177, $9,215, and $7,978, respectively.

**E.** The Company has provided, on a proportional basis to its ownership interest, guarantees for two of its investees in respect of credit lines from banks amounting to $13,900 (2002- $10,600), of which $13,400 (2002 - $10,200) relates to a owned 50% foreign investee. The guarantees will exist as long as the credit lines are in effect. The Company would be liable to perform under the guarantee for any debt the investee would be in default under the terms of the credit line.

## *Note 16 – COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)*

**F.** A lien on the Group's Approved Enterprises has been registered in favor of the State of Israel. Grants received in respect of projects which have not yet been approved amount to approximately $800 (see Note 15 A (3) above ).

**G.** Guarantees in the amount of approximately $399,200 were issued by banks securing certain advances from customers and performance bonds on behalf of Group companies.

**H.** Certain Group companies recorded fixed charges on most of their machinery and equipment, mortgages on most of their real estate and floating charges on most of their assets.

## *Note 17 – SHAREHOLDER'S EQUITY*

**A. SHARE CAPITAL**

Ordinary shares confer upon their holders voting rights, the right to receive dividends and the right to share in equity upon liquidation of the Company.

**B. 2000 EMPLOYEE STOCK OPTION PLAN**

In 2000, the Company adopted an employee stock option plan for employees comprising options to purchase up to 2,500,000 Ordinary shares. The exercise price approximates market price of the shares at the grant date. The plan includes an additional 2,500,000 options to be issued as "phantom" shares options that grant the option holders a number of shares reflecting the benefit component of the options exercised, as calculated at the exercise date, in consideration for their par value only. Options vest over a period of one to four years from the date of grant and expire no later than six years from the date of grant.

Any options, which are canceled or forfeited before expiration, become available for future grants. As of December 31, 2003, 479,217 options of the Company were still available for future grants.

**C. "PHANTOM" SHARE OPTIONS**

The phantom share options are considered as part of a variable plan as defined in APB No. 25, and accordingly the compensation cost of the options is measured by the difference between the market price of the Company's shares and the exercise price of the options at the end of every reporting period and amortized by the accelerated method over the remaining vesting period.

## *Note 17 – SHAREHOLDER'S EQUITY (Cont.)*

**D.** A summary of the Company's share option activity under the plans is as follows:

| | December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2003 | | 2002 | | 2001 | |
| | Number of options | Weighted average exercise prices | Number of options | Weighted average exercise prices | Number of options | Weighted average exercise prices |
| **Outstanding-beginning of the year** | 4,511,724 | $ 12.26 | 5,107,634 | $ 11.93 | 5,671,918 | $ 11.26 |
| Granted | 13,000 | 14.91 | 27,000 | 14.92 | 98,840 | 12.91 |
| Exercised | (757,947) | 12.13 | (558,901) | 9.45 | (598,348) | 11.93 |
| Forfeited | (31,175) | 12.29 | (64,009) | 11.33 | (64,776) | 12.50 |
| **Outstanding - end of the year** | **3,735,602** | **$ 12.30** | **4,511,724** | **$ 12.26** | **5,107,634** | **$ 11.93** |
| **Options exercisable at the end of the year** | **2,547,196** | **$ 12.23** | **2,287,790** | **$ 12.18** | **373,138** | **$7.56** |

**E.** The options outstanding as of December 31, 2003, have been separated into ranges of exercise price, as follows:

| | Options outstanding | | | Options exercisable | |
|---|---|---|---|---|---|
| Exercise prices | Number outstanding as of December 31, 2003 | Weighted average remaining contractual life (years) | Weighted average exercise prices per share | Number outstanding as of December 31, 2003 | Weighted average exercise prices per share |
| $10.61-$12.16 | 158,935 | 0.42 | $10.69 | 158,935 | $10.69 |
| $12.18-$15.64 | 1,786,193 | 2.93 | 12.37 | 1,190,240 | 12.34 |
| $12.18-$15.64(*) | 1,790,474 | 2.94 | 12.37 | 1,198,021 | 12.33 |
| | **3,735,602** | **2.83** | **$12.30** | **2,547,196** | **$12.23** |

(*) Phantom share options.

Where the Company has recorded deferred stock compensation for options issued with an exercise price below the fair value of the Ordinary shares, the deferred stock compensation is amortized and recorded as compensation expense ratably over the vesting period of the options. Compensation expense (income) of $4,741, $(926) and $8,512 were recognized during the years ended December 31, 2003, 2002 and 2001, respectively.

## *Note 17 – SHAREHOLDER'S EQUITY (Cont.)*

**F.** The weighted average exercise price and fair value of options granted during the years ended December 31, 2003, 2002 and 2001 were:

| | Less than market price | | |
|---|---|---|---|
| | Year ended December 31, | | |
| | 2003 | 2002 | 2001 |
| Weighted-average exercise price | $ 14.91 | $ 14.92 | $ 12.91 |
| Weighted-average fair values on grant data | $ 4.63 | $ 4.31 | $ 5.14 |

**G.** Computation of basic and diluted net earnings per share:

| | Year ended December 31, 2003 | | | Year ended December 31, 2002 | | | Year ended December 31, 2001 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Net income to shareholders of ordinary shares | Weighted averaged number of shares* | Per share amount | Net income to shareholders of ordinary shares | Weighted averaged number of shares* | Per share amount | Net loss to shareholders of ordinary shares | Weighted averaged number of share* | Per share amount |
| Basic net earnings $ | 45,945 | 39,061 | $1.18 | $45,113 | 38,489 | $1.17 | $40,796 | 37,975 | $1.07 |
| Effect of dilutive securities: Emoloyee stock options | - | 1,169 | | - | 1,374 | | - | 1,384 | |
| **Diluted net earnings** | **$45,945** | **40,230** | **$1.14** | **45,113** | **39,863** | **$1.13** | **$40,796** | **39,359** | **$1.04** |

* In thousands

**H. TREASURY SHARES**

The Company's shares held by the Company are presented at cost and deducted from shareholder's equity.

**I. DIVIDEND POLICY**

Dividends declared by the Company are paid in NIS or in foreign currency subject to any statutory limitations. The Company has decided not to declare dividends out of tax exempt earnings.

## *Note 18 – MAJOR CUSTOMER AND GEOGRAPHIC INFORMATION*

The Group adopted Statement of Financial Accounting Standards No. 131, "Disclosures About Segments of an Enterprise and Related Information", ("SFAS No. 131"). The Group operates in one reportable segment (see Note 1 for a brief description of the Group's business).

| | Year ended December 31, | | |
|---|---|---|---|
| | **2003** | **2002** | **2001** |
| **A.** Revenues are attributed to geographic areas based on location of the end customers as follows: | | | |
| Europe | $109,409 | $144,862 | $179,560 |
| U.S. | 332,323 | 267,686 | 206,627 |
| Israel | 255,742 | 225,674 | 226,650 |
| Other | 200,506 | 189,234 | 151,664 |
| | **$897,980** | **$827,456** | **$764,501** |
| **B.** Revenues are generated by the following product lines: | | | |
| Airborne systems | $373,580 | $372,756 | $334,201 |
| Land systems | 199,800 | 135,700 | 126,300 |
| $C^4$ISR systems | 133,900 | 122,700 | 105,800 |
| Electro-optical systems | 140,500 | 148,200 | 162,700 |
| Others | 50,200 | 48,100 | 35,500 |
| | **$897,980** | **$827,456** | **$764,501** |
| **C.** Revenues from single customer, which exceed 10% of total revenues in the reported years: | | | |
| Customer A | 21% | 18% | 20% |
| **D.** Long-lived assets by geographic areas: | | | |
| Israel | $229,396 | $211,256 | $84,864 |
| U.S. | 81,261 | 83,814 | 194,690 |
| Others | 18,093 | 13,660 | 10,451 |
| | **$328,750** | **$308,730** | **$290,005** |

### *Note 19 – RESEARCH AND DEVELOPMENT COSTS, NET*

| | Year ended December 31, | | |
|---|---|---|---|
| | **2003** | **2002** | **2001** |
| Total expenses | $65,487 | $62,560 | $67,871 |
| Less – participations | (10,568) | (5,550) | (9,112) |
| | **$54,919** | **$57,010** | **$58,759** |

### *Note 20– FINANCIAL EXPENSES, NET*

| | Year ended December 31, | | |
|---|---|---|---|
| | **2003** | **2002** | **2001** |
| **EXPENSES:** | | | |
| On long-term bank debt | $2,719 | $2,026 | $3,033 |
| On short-term bank credit and loans | 2,838 | 3,415 | 3,806 |
| Others | 5,600 | 1,214 | 798 |
| | **11,157** | **6,655** | **7,637** |
| **INCOME:** | | | |
| Interest on cash, cash equivalents and bank deposits | 309 | 1,547 | 2,179 |
| Others | 5,978 | 2,073 | 2,841 |
| | **6,287** | **3,620** | **5,020** |
| | **$4,870** | **$3,035** | **$2,617** |

### *Note 21 – OTHER INCOME (EXPENSES), NET*

| | Year ended December 31, | | |
|---|---|---|---|
| | **2003** | **2002** | **2001** |
| Gain (loss) on sale of property, plant and equipment | $ 915 | $(743) | $327 |
| Other, net | (12) | 281 | 447 |
| | **$903** | **$(462)** | **$774** |

## *Note 22 – RELATED PARTIES TRANSACTIONS AND BALANCES*

| | Year ended December 31, | | |
|---|---|---|---|
| | 2003 | 2002 | 2001 |
| **INCOME** | | | |
| Sales (*) | $ 34,674 | $37,924 | $28,675 |
| Expenses charged | $ 1,773 | $ 902 | $ 633 |
| **COST AND EXPENSES** | | | |
| Supplies and services | $ 21,606 | $10,457 | $11,125 |
| Participation in expenses (*) | $ 1,751 | $ 1,498 | $1,632 |
| Financial expenses | $ 23 | $ 110 | $ 193 |

| | December 31, | |
|---|---|---|
| | 2003 | 2002 |
| Trade receivables (*) | $ 6,668 | $ 9,647 |
| Trade payables | $ 4,975 | $ 4,006 |

(*) The amounts relate mainly to transactions with VSI.

## *Note 23 – RECONCILIATION TO ISRAELI GAAP*

As described in Note 2, the Company prepares its financial statements in accordance with U.S. GAAP. The effects of the differences between U.S. GAAP and Israeli GAAP on the Company's financial statements are detailed below.

Differences between U.S. GAAP and Israeli GAAP:

**A building purchased from Elbit Ltd.**
According to generally accepted accounting principles in Israel ("Israeli GAAP"), the Company charged to capital reserves the excess of the amount paid over net book value of a building acquired from Elbit Ltd in 1999.

According to U.S. GAAP, the entire amount paid is considered as the cost of the building acquired.

**Proportional consolidation method**
According to Israeli GAAP, a jointly controlled company should be included according to the proportional consolidation method. According to U.S. GAAP, the investment in such a company is recorded according to the equity method.

## *Note 23 – RECONCILIATION TO ISRAELI GAAP (Cont.)*

**Tax benefit in respect of options exercised**

According to Israeli GAAP, tax benefits from employee options exercised are recorded as a reduction of tax expense. According to U.S. GAAP, the difference between the above mentioned tax benefits and the benefits recorded in respect of compensation expense in the financial statements is credited to capital reserves.

**Goodwill**

Effective January 1, 2002, the Company adopted SFAS 142, "Goodwill and Other Intangible Assets" according to which goodwill and intangible assets with indefinite lives are no longer amortized periodically but are reviewed annually for impairment (or more frequently if impairment indicators arise). According to Israeli GAAP, all intangibles, including goodwill should be amortized.

**1. Effect on net income and earnings per share**

| | Year ended December 31, | | |
|---|---|---|---|
| | **2003** | **2002** | **2001** |
| Net income as reported according to US GAAP | $ 45,945 | $ 45,113 | $ 40,796 |
| Adjustments to Israeli GAAP | 595 | (4,227) | 1,767 |
| **Net earnings according to Israeli GAAP** | **$ 46,540** | **$ 40,886** | **$ 42,563** |

**2. Effect on shareholders' equity**

| | **As reported** | **Adjustments** | **As per Israeli GAAP** |
|---|---|---|---|
| **AS OF DECEMBER 31, 2003** | | | |
| Shareholders' equity | $452,079 | $(10,367) | $441,712 |
| **AS OF DECEMBER 31, 2002** | | | |
| Shareholders' equity | $ 411,361 | $ (11,076) | $400,285 |